Coase and Durable Goods

Coase’s (1972) analysis of durable goods does not give us a very good understanding of the issues of pricing.\(^1\) In fact, Coase’s main conclusion is wrong and, beyond that, the whole paper is misleading. Durability is a multifaceted concept that cannot be summarized as succinctly as Coase leads us to believe.

Coase argues that if there were a monopoly owner of land, this owner could get no more for the land than the competitive price. This occurs because all buyers anticipate that all the land will eventually be sold and that the final selling price will be the competitive price. Hence, all buyers “rationally” withhold their purchases until the price falls. In the face of such an atomistic cartel among buyers, the monopolist is forced to price land at the competitive level from the get go.

Before we dissect the logic of Coase’s model, let’s ponder its empirical merit. Consider the following goods:

- Light Bulbs
- Food & Drugs
- Autos
- Cameras
- Books & Movies

What does “durability” mean in each of these cases?

We generally don’t think of food as being durable. However, it obviously is. For instance, we could rephrase the light bulb question in terms of the shelf life of some food product. The same is true for drugs. Also, there are a lot of patents and trade secrets in the food and drug business. Hence, there is a lot of pricing that is very reasonably discussed in terms of monopoly power. If we were told that Frito-Lay just discovered a way to make their fat-free potato chips keep twice as long on the shelf, would Coase’s durability model tell us anything about how that would affect the price of the product? If so, what?

Automobiles are obviously durable goods. Folklore claims that auto dealers discount cars less at the beginning of the sales year than at the end. What explains this?

Polaroid has a monopoly on its kind of film processing. I have not paid much attention in recent years, but thirty years ago, Polaroid had some major break-throughs in the way its film worked. I remember that when it introduced its new film, the first cameras that it sold were very expensive. I am not sure to what extent we might consider the film as a durable good, but the cameras clearly are in the same sense as an auto. In the case of the new Polaroid cameras, everyone knew that the company would begin selling cheaper cameras

after some time and, of course, that is what happened. How is this consistent with the Coase model?

In the case of books and movies, the copyright holder has a monopoly on the good. The good is durable in the sense that once it is produced, it costs very little to reproduce it. Indeed, books and movies are arguably public goods in that they are non-rivalrous in consumption. However, the durability on the production side is not mimicked by durability on the consumption side. With books and movies, once they are read or viewed, the consumer often has little continuing interest in them. Unlike autos where the consumption of a unit of the good lasts a long time but the production process has only a few elements of durability, in books and movies, the consumption period is very brief but the production process is almost completely durable.

The pricing of books and movies that we observe is nearly identical to the case of the new-vintage Polaroid cameras, that is, the monopolist walks down the demand curve. The first printing of books is done in hardback. The books are priced expensively. Next they are distributed via book clubs. Then the hardbacks are discounted at the book stores. Finally, the paper back printing is released. Movies follow much the same scheme. Movies are first shown at what are called “first-run” theaters. Next they go to discount theaters and to HBO/Cinemax. Then the VCR video is released. Finally, they show up on broadcast TV. Is this what Coase’s model predicts?

So, what does Coase’s model tell us? In my opinion, not much. I do not think that the concept of durability can be well defined. It seems to me that durability has many facets and there is no way to slap a “durability” label on a given problem and say this means “ya, ya, ya, …”.

Specifically, in the case of light bulbs, potato chips, and automobiles, it seems to me that the durability implications are transparent. Obviously, the more durable is a car, the more a buyer is willing to pay for it. The same is true for light bulbs. While there is no direct resale market for light bulbs, there is for cars. It is obvious that the amount a buyer is willing to pay for a new cars is conditioned on what the car will be worth in the used market. However, none of this is requires a very sophisticated model, and I don’t think that any of Coase’s predictions come into play.

In the case of movies and books and new technology products, Coase’s theory is directly refuted by the facts. Monopolists consistently price down the demand curve in one way or another. To claim that the price immediately falls to marginal cost is contrary to all available evidence.

So what is wrong with Coase’s theory? Coase only examines the problem from the point of view of the buyers. We get a different solution if we think about this problem from the

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2 One might argue that the housing market acts as a used light bulb market. Most people do not take the light bulbs when they leave. In fact, if the house has special long lasting light bulbs, this fact will probably be advertised as a selling point.
point of view of the monopolist. Let’s say that to get the monopoly in land, the firm had to buy the land at the competitive price. What would be the point of buying the land at the competitive price and then selling the land back at the competitive level? Essentially nothing. The same is true in the case of a manufactured durable good; the value of selling at marginal cost is zero profit. Logically, then, if the monopolist has nothing to gain from discounting its price, it won’t. At least not immediately.

What Coase has modeled but fails to recognize is essentially a stalemate between buyers and sellers. In Coase’s mind, the buyers correctly anticipate that the monopolist will lower its price eventually. Therefore he argues that buyers will hold out until the monopolist is forced to lower its price and because the monopolist anticipates this, it immediately sets its price at marginal cost. However, if the monopolist lowers its price immediately, it gains nothing. Hence, there is a stalemate between buyers and the monopolist. The buyers want to withhold their purchases until price falls and the monopolist wants to keep its high prices until it captures some consumer surplus from the high end of the demand curve.

It seems to me that the stalemate will always be won by the monopolist. The monopolist in Coase’s model will put the good (land or the durable manufactured product) on the market at a high price, and it will not discount until that supply is sold at that price. There is no need for any demonstration that no more of the product will be sold. Indeed, everyone recognizes that more will be sold and at a lower price. But everyone recognizes that this discounting will only occur after the first batch is sold at a high price. Moreover, there is no reason for the monopolist to spend resources to convince people that this will happen because everyone knows that this is the profit maximizing behavior for the monopolist.

What is unanswered is which buyers pay the high price and which wait for the lower price. It is not exactly clear what assumption Coase makes about demand. Downward sloping demand means that either consumers are heterogeneous, that is, consumers differ in the intensity of their demands, or the good is one where each consumer buys multiple units. If consumers differ, then the most intense buyers go first. They pay the high prices for Polaroid cameras, hard back books, first run movies, and the first arrivals of the new model cars. If demand is downward sloping because consumers buy multiple units, then each consumer buys some of the good at the high price and then some more at the lower prices as the monopolist walks down the demand curve.

To conclude this discussion, later in the semester we will work through a learning curve model that makes the same prediction about pricing but for somewhat different reasons. The empirical application is the pricing of new computers.

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3 Take, for instance, the land that Duke Power bought to build the Oconee plant. It is now selling that land in various real estate ventures such as the Keowee Key development.